

I. Introduction

Public company accounting and auditing standards are promulgated, monitored and enforced by a number of regulatory bodies. The objectives of this whitepaper are to discuss the evolution of financial accounting regulation through 2005 for U.S. public companies¹, to discuss the impact to U.S. public companies (i.e. the accounting and disclosure rules and reporting requirements) resulting from this regulation, and to identify the regulatory bodies affecting this impact through the promulgation, oversight or enforcement of regulation on public companies in today's environment.

On July 25, 2002, Congress passed the Sarbanes-Oxley Act of 2002, and President Bush signed it into law on July 30, 2002. This Act is the most comprehensive reform since the Securities Act of 1933 and the Securities Exchange Act of 1934; it covers a variety of areas, and seeks, among other things, to promote corporate responsibility, enhance public disclosure, and improve the quality and transparency of financial reporting by U.S. public companies. This legislation has a number of important implications for public companies, including their management, audit committees, independent auditors and attorneys, as well as analysts and investors.

The U.S. Securities and Exchange Commission² ("SEC") is the principal regulatory agency governing the U.S. securities markets and publicly traded companies. The SEC is legally charged with establishing accounting policies in the United States, but relies on private standards-setting bodies such as the Financial Accounting Standards Board ("FASB") and the Public Company Accounting Oversight Board ("PCAOB"). The SEC has empowered the FASB and PCAOB, respectively, as the authoritative accounting standard-setter and auditing standard-setter for public companies having registered securities on a U.S. national exchange.

The FASB³ is an independent standards-setting board comprised of members from industry, the accounting profession and academia. The SEC relies on the FASB to establish Generally Accepted Accounting Principles in the United States ("U.S. GAAP") through a prescribed standard-setting process. Financial statements filed with the SEC that are not in conformity with U.S. GAAP are considered to be misleading or inaccurate, and are therefore unacceptable to the SEC.

The PCAOB⁴, a private sector, non-profit corporation created by the Sarbanes-Oxley Act of 2002, replaced the American Institute of Certified Public Accountants ("AICPA"), a self-regulating body of the accounting profession, as the primary oversight of auditors of U.S. public companies.

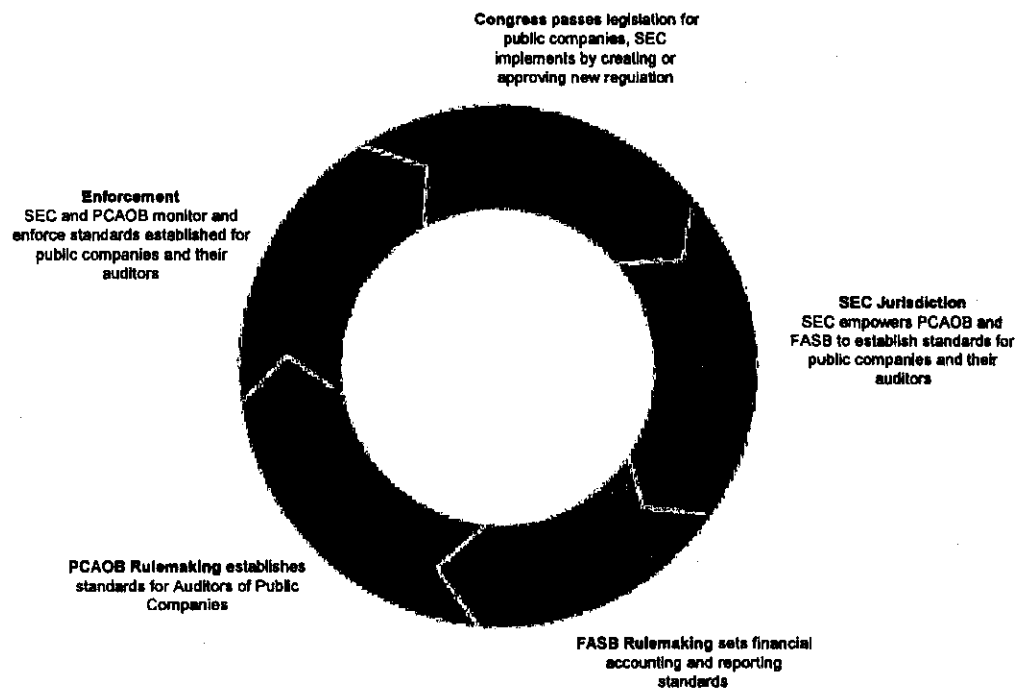
¹ A U.S. public company is defined as a company that has issued securities in an offering registered under the 1933 Securities Act or has registered the company's outstanding securities under the 1934 Securities Exchange Act requirements.

² For a more in-depth discussion about the SEC, see Appendix A

³ For a more in-depth discussion about the FASB, see Appendix B

⁴ For a more in-depth discussion about the PCAOB, see Appendix C

In order for the FASB's accounting and reporting rules (U.S. GAAP) to be effective as promulgated, the Sarbanes-Oxley Act of 2002 has prescribed monitoring and oversight rules for public companies and their auditors. A public company is subject to many layers of oversight both internally and externally by its internal audit department, chief executives and audit committee, as well as its external auditors, the PCAOB and the SEC. Further, the SEC and PCAOB investigate alleged infractions and enforce these accounting and auditing rules through a variety of means from penalties and fines to deregistration and imprisonment.



All U.S. public companies are subject to the federal regulations of the SEC. A U.S. public company is also subject to other federal and state regulations and statutes affecting all companies, such as Federal Trade Commission consumer protection requirements and anti-trust laws, for example.

II. Critical Milestones in Accounting Regulation¹ ⁱⁱ

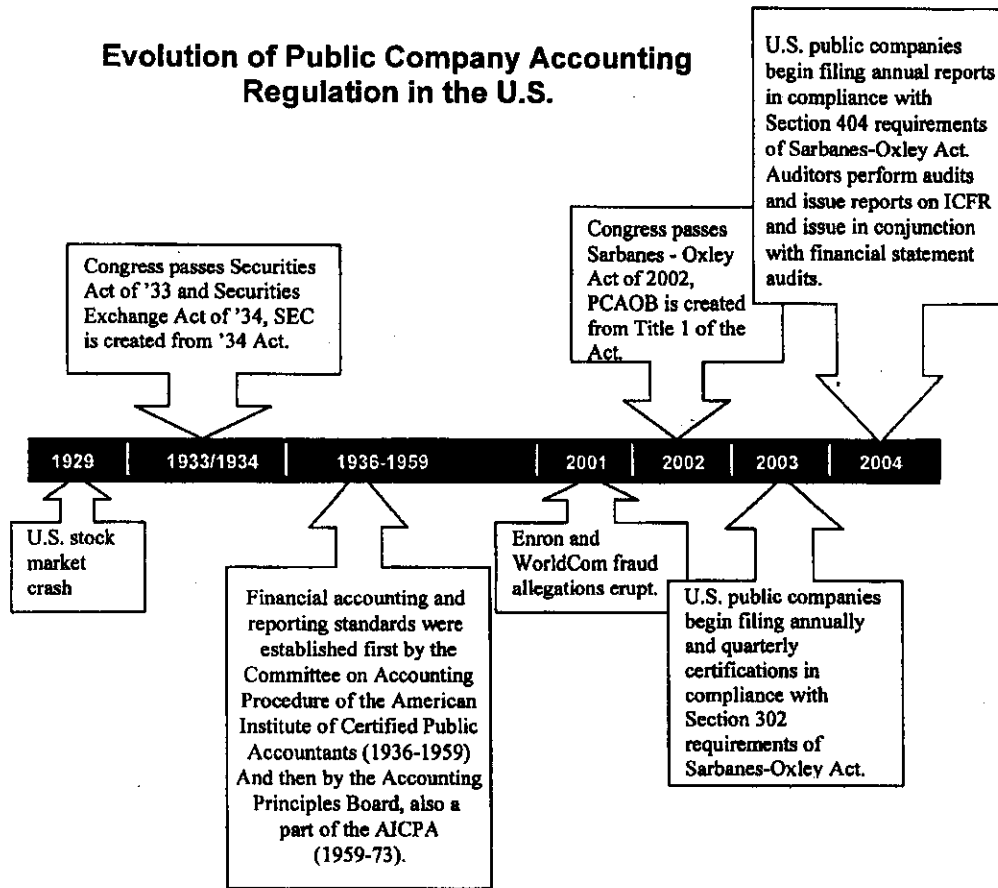
In an effort to restore public confidence and trust in the U.S. capital markets after the stock market crashed in October 1929, Congress passed the Securities Act of 1933 ("the '33 Act") and the Securities Exchange Act of 1934 ("the '34 Act"). With the passage of the '34 Act, the SEC, an independent, nonpartisan, regulatory agency, was created to provide more structure and government oversight by regulating the securities markets. The '33 Act and '34 Act place direct responsibility on officers and directors of public companies, underwriters, auditors, and attorneys for the accuracy of the financial information provided and compliance with the securities laws and regulations.

On July 25, 2002, Congress passed the Sarbanes-Oxley Act of 2002, and President Bush signed it into law on July 30, 2002. The Act represents a major development in the push to reform corporate accountability in the U.S. Broadly, the legislation addresses corporate reform in light of a series of business failures and corporate scandals that began with Enron in 2001. More specifically, the Act covers a variety of areas and seeks, among other things, to promote corporate responsibility, enhance public disclosure, improve the quality and transparency of financial reporting, create the PCAOB to oversee the accounting profession, protect the objectivity of research analysts, and strengthen penalties for violations of securities law. This legislation has a number of important implications for both public companies and their independent auditors.

The most significant change brought about by the Sarbanes-Oxley Act is its emphasis on the effectiveness of a public company's systems of internal controls. Effective internal controls are fundamental to investor confidence in financial reporting because they help to deter fraud and to prevent inaccurate financial statements. Under the Sarbanes-Oxley Act, U.S. public companies are now subject to new requirements for management and independent auditors to assess, document and report on the effectiveness of Internal Control over Financial Reporting ("ICFR"). Prior to the Sarbanes-Oxley Act, management was not required to formally assess and document their internal controls, and was only required to report material weaknesses found in the course of an audit to their audit committee. Furthermore, independent auditors were required to assess internal controls only to the extent it was required in order to plan their audit.

The most visible change of the Sarbanes-Oxley Act is the inclusion of new reports and certifications in public filings with the SEC by company management on their assessment of the effectiveness of the company's ICFR, and supplemental opinions included in the independent auditor's report on the company's external financial statements; these additions include, the auditor's opinions on management's assessment on ICFR, and on the effectiveness of the company's ICFR.

Evolution of Public Company Accounting Regulation in the U.S.



III. U.S. Public Company Financial Accounting Rules and Disclosures in Reporting

U.S. public companies are required to present their financial statements in conformity with accounting principles generally accepted in the United States of America, collectively referred to as U.S. GAAP. Financial statements are defined herein to include the balance sheet, statement of income, statement of shareholders' equity, statement of changes in cash flows, and the explanatory notes to these statements.

A. Financial Statements in Conformity with U.S. Generally Accepted Accounting Principles ("U.S. GAAP")

The overall accuracy of the financial statements, including interim financial information, and their conformity with U.S. GAAP is the responsibility of the company's management. In this regard, management has the responsibility for, among other things:

- Establishing and maintaining effective internal control over financial reporting
- Identifying and ensuring that the company complies with the laws and regulations applicable to its activities
- Presenting financial statements that are in conformity with U.S. GAAP and adjusting the financial statements to correct any material misstatements

"In the area of financial reporting, one of management's most important functions is to provide full and accurate information to the company's owners and potential owners."

*Commissioner Cynthia A. Glassman,
U.S. Securities and Exchange Commission*

B. U.S. GAAP

U.S. GAAP establishes rules around the recording, reporting and disclosing of transactions by companies. By requiring that all companies present their financial statements in accordance with GAAP, consistency and standardization in presentation is improved, and misinterpretation by readers of financial statement is reduced. U.S. GAAP includes, for example, a number of pronouncements related to each of the following:⁵

- Revenue recognition disclosure, timing and measurement
- Related party transaction valuation and disclosure
- Estimations of accruals, indirect cost allocations, etc.
- Impairment and restructuring charges
- Business combinations, goodwill and other intangible assets (FAS 141 / 142)
- Segment reporting (reporting disaggregated information by geographic, division, industry/product, or distinction used internally by management in decision-making)
- Other than temporary impairment
- Loss contingencies

⁵ For a detailed list of GAAP pronouncements, see Appendix D

Current U.S. GAAP comprises over 2,000 pronouncements issued by different organizations – the FASB, the Emerging Issues Task Force (“EITF”), the Accounting Principles Board (APB) created by the FASB, the Accounting Standards Executive Committee (AcSEC) of the AICPA, and the SEC in a variety of forms.

While the SEC has the statutory authority to prescribe accounting and reporting principles for public companies, it has allowed the standard-setting bodies designated by the accounting profession to provide leadership in establishing and improving the accounting principles. The SEC has declared the FASB as the authoritative standard setter in establishing U.S. GAAP.^{6 iii} Due to the number of entities that have historically contributed to the creation of these accounting principles, the accounting profession has followed an established hierarchy for the various sources of authoritative accounting pronouncements in the United States.

The current GAAP hierarchy is organized as follows:^{iv}

Level A FASB Statements, FASB Interpretations, APB Opinions, Accounting Research Bulletins (“ARBs”), SEC Staff Accounting Bulletins (“SABs”)⁷

Level B FASB Technical Bulletins, AICPA Industry Guides, AICPA Statements of Position (“SOPs”)

Level C EITF Consensuses, AICPA AcSEC Practice Bulletins

Level D FASB Staff Implementation Guides, Derivatives Implementation Group Consensuses, FASB Staff Positions, FASB Concepts Statements, AICPA Issues Papers

If the accounting treatment for a transaction or event is not specified by a pronouncement in Level A, a company should consider whether the accounting treatment is specified by an accounting principle from a source in Levels B-D, and should follow the accounting treatment specified by the accounting principle from the source in the highest level, for example, follow level B treatment over level D.^v

A company cannot represent that its financial statements are presented in accordance with U.S. GAAP if its selection of accounting principles departs from the U.S. GAAP hierarchy and that departure has a material impact on its financial statements.^{vi}

⁶ For a more in-depth discussion of the FASB, see Appendix B: FASB.

⁷ For a detailed list of Level A U.S. GAAP accounting rules, see Appendix D.

IV. U.S. Public Company Internal Controls Over Financial Reporting ("ICFR") Rules

A. Sarbanes-Oxley Act of 2002 ⁸

From the Sarbanes-Oxley Act came a series of rules for assessing the effectiveness of a public company's internal controls in order to fulfill the Act's mandate for reform - to enhance corporate responsibility, enhance financial disclosures and combat corporate and accounting fraud. This reform has impacted the financial reporting process, and the systems, policies and procedures underlying it, for U.S. public companies.

Under the Sarbanes-Oxley Act, U.S. public companies are now subject to new requirements for management and independent auditors to assess, document and report on the effectiveness of ICFR. Prior to the Sarbanes-Oxley Act, management was not required to formally assess and document their internal controls, and was only required to report material weaknesses found in the course of an audit to their audit committee. Furthermore, independent auditors were required to assess internal controls only to the extent it was required in order to plan their audit.

Importance of Internal Controls

PCAOB adopted Auditing Standard No. 2 "An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements" states that management's assessment of the effectiveness of its internal control over financial reporting must be based on a suitable, recognized control framework that has been established by a body of experts. In the United States, the most broadly accepted framework is that created by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"), and it is used by the large majority of U.S. companies. The SEC has stated that the COSO framework satisfies its criteria, but it has not mandated its use.⁹

COSO defines internal control as a process implemented by a company's board of directors, management, and other personnel that is designed to provide reasonable assurance that an organization can achieve its objectives in three interrelated areas:

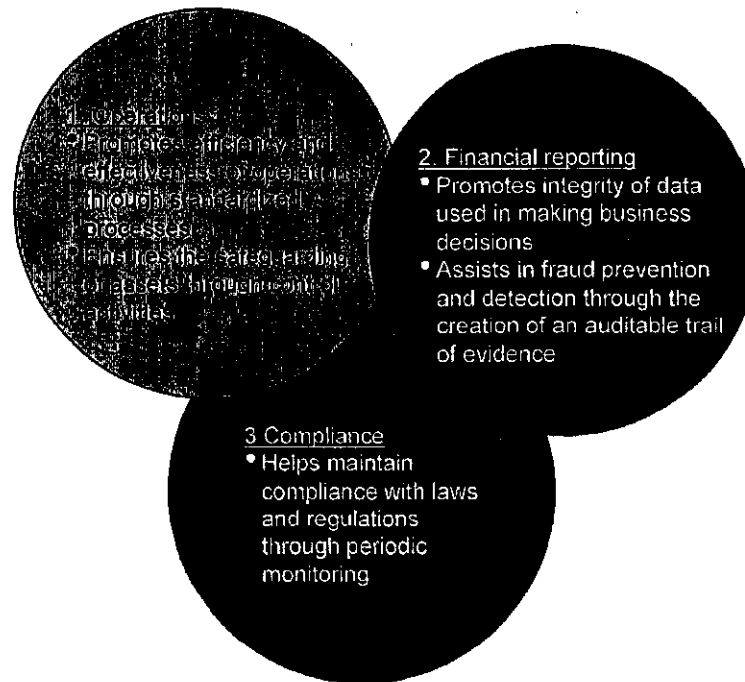
1. Effective and efficient operations
2. Reliable financial reporting
3. Compliance with applicable laws and regulations

Reliable financial reporting is dependent, in part, on the achievement of the other objectives and vice versa. Section 404 of the Sarbanes-Oxley Act relates to the internal control objective of reliable financial reporting, and requires public company management to design and implement a system of internal control over financial

⁸ For a list and detailed description of the Sarbanes-Oxley Act by Title, see Appendix E.

⁹ For a more in-depth discussion of the COSO framework adopted by the majority of U.S. public companies, see Appendix F.

reporting; evaluate the effectiveness of the company's internal control over financial reporting and provide a public report on that assessment.



The COSO framework presents five related components of internal control:

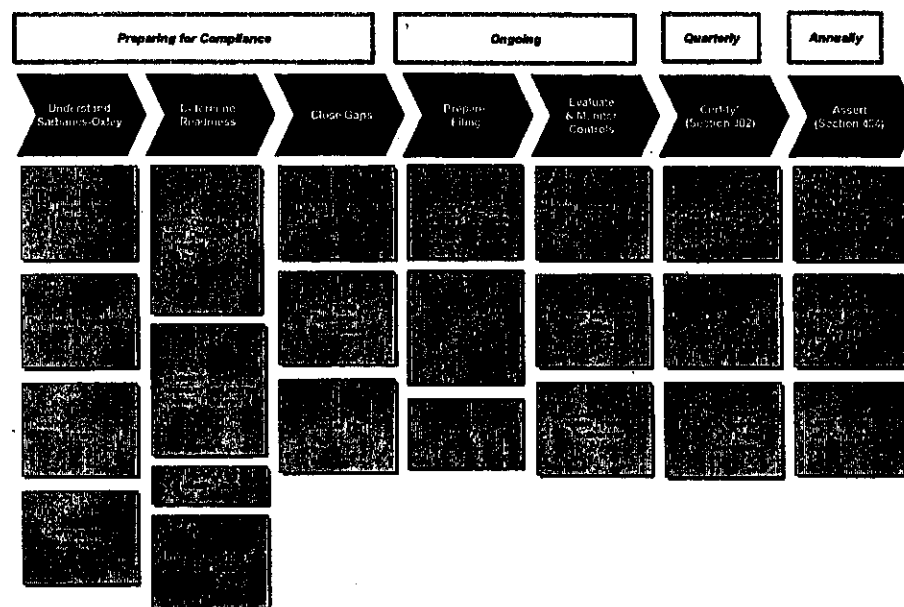
- Control environment
- Risk assessment
- Control activities
- Information and communication
- Monitoring controls

PCAOB adopted Auditing Standard No. 2 requires that company management:

- Accept responsibility for the effectiveness of the Company's internal control over financial reporting
- Evaluate the effectiveness of the Company's internal control over financial reporting using suitable control criteria (e.g., the COSO framework)
- Support its evaluation with sufficient evidence, including documentation
- Present a written assessment of the effectiveness of the Company's internal control over financial reporting as of the year end date under audit.

Public company perspective for complying with Sections 302 and 404

Public companies follow a multi-step process to comply with the requirements of Sections 302 and 404 of the Sarbanes-Oxley Act, as set forth in the chart^{vii} below.



V. U.S. Public Company Reporting Requirements

A. Securities and Exchange Commission Reporting Requirements^{viii 10}

The two primary Acts administered by the SEC are the Securities Act of 1933 and the Securities Exchange Act of 1934. Both of these have been revised over the years through amendments to increase the emphasis on disclosure in reporting.

The SEC has broad powers in interpreting and governing accounting and disclosure matters, principally through the issuance of rules and regulations that have the force of law, most notably Regulations S-X (rules prescribing the form and content of audited and unaudited financial statements) and S-K (disclosure provisions pertaining to information that is generally not a part of the financial statements on which auditors express an opinion). The SEC also issues non-binding statements, such as Staff Accounting Bulletins and Staff Legal Bulletins that reflect the SEC's views on matters, though they are not the equivalent of rules and regulations.

¹⁰ For additional discussion on these and other SEC rules and regulations, see Appendix A.

The Securities Exchange Act of 1934 ("the '34 Act") covers periodic reporting requirements for companies with publicly registered securities.

1. Periodic Reporting Requirements

There are a number of critical periodic informational reporting requirements under the '34 Act for public companies. At a minimum, a public company is required to file an annual report on the Form 10-K and three quarterly reports on the Form 10-Q each year.

Form 10-K – the annual report form for most U.S. issuers is the Form 10-K, which requires audited financial statements and schedules in accordance with Regulation S-X and certain non-financial disclosures in accordance with Regulation S-K. Financial statements to be included in the 10-K generally include two years' balance sheets, and three years' statements of income, statements of changes in shareholders' equity, and statements of changes in cash flows in addition to the notes to the financial statements covering these periods.

There are 15 required disclosure "items" to be included in Form 10-K in addition to the financial statements. They are:

- Items 1, 2 and 3—Description of Business, Properties and any Legal Proceedings
- Items 4 and 5—Submission of Matters to a Vote of Security Holders and Market Price of Stock
- Item 6—Selected Financial Data
- Item 7—Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A)
- Item 7A—Quantitative and Qualitative Disclosures About Market Risk
- Item 8—Financial Statements and Supplementary Data
- Item 9—Changes In and Disagreements with Accountants on Accounting and Financial Disclosure
- Items 10, 11, and 12—Directors and Executive Officers of the Registrant and Executive Compensation, and Security Ownership of Certain Beneficial Owners and Management
- Item 13—Certain Relationships and Related Transactions
- Item 14—Exhibits, Financial Statement Schedules and Reports on Form 8-K

Form 10-Q – the quarterly report form utilized by most companies. Form 10-Q calls for the inclusion of unaudited condensed financial and certain other information reviewed by a public company's independent accountants. Condensed financial statements to be included in this filing include:¹¹

- An interim balance sheet as of the end of the most recent fiscal quarter and a balance sheet as of the end of the preceding fiscal year.

¹¹ Per Regulation S-X, Article 10, Rule 10-01 Interim Financial Statements

- Interim statements of income for the most recent fiscal quarter, for the period between the end of the preceding fiscal year and the end of the most recent fiscal quarter, and for the corresponding periods of the preceding fiscal year. Such statements may also be presented for the cumulative twelve month period ended during the most recent fiscal quarter and for the corresponding preceding period.
- Interim statements of changes in cash flows for the period between the end of the preceding fiscal year and the end of the most recent fiscal quarter, and for the corresponding period of the preceding fiscal year. Such statements may also be presented for the cumulative twelve month period ended during the most recent fiscal quarter and for the corresponding preceding period

Per Article 10 of Regulation S-X, Rule 10-01-- Interim Financial Statements, "Registrants must obtain reviews of interim financial information by their independent auditors starting with their Forms 10-Q to be filed for fiscal quarters ending on or after March 15, 2000. These interim financial statements must be reviewed by an independent public accountant using professional standards and procedures for conducting such reviews, as established by generally accepted auditing standards, as may be modified or supplemented by the Commission."

Part I Financial Information

- Item 1. Financial Statements
- Item 2. Management's Discussion and Analysis
- Item 3. Quantitative and Qualitative Disclosures About Market Risk
- Item 4. Controls and Procedures

Part II Other Information

- Item 1. Legal Proceedings
- Item 2. Unregistered Sales of Equity Securities and Use of Proceeds
- Item 3. Defaults Upon Senior Securities
- Item 4. Submission of Matters to a Vote of Security Holders
- Item 5. Other Information
- Item 6. Exhibits

Part III Review by Independent Registered Public Accounting Firm

B. Sarbanes-Oxley Reporting ¹²

As stated in the Sarbanes-Oxley Act, the Act is designed to protect investors by improving the accuracy and reliability of corporate disclosures, and thus, by requiring company certifications and assessments and other additional reporting requirements.

1. Certifications – Section 302

This section of the Sarbanes-Oxley Act requires a company's chief executive officer and chief financial officer to certify each quarterly (10-Q) and annual report (10-K). Under Section 302 and the related SEC rules, the officers are required to certify that:

- The financial statements and other financial information included in the report are presented fairly in all material respects.
- The report does not contain any untrue statement of material fact or fail to state a material fact.
- The certifying officers are responsible for establishing and maintaining disclosure controls and procedures sufficient to ensure that the financial and nonfinancial information required to be disclosed in SEC reports is recorded, processed, summarized, and reported within specified periods.
- The certifying officers have evaluated the effectiveness of the company's disclosure controls and procedures as of the end of the period covered by the report.
- The certifying officers have disclosed to the auditors and the audit committee all significant deficiencies and material weaknesses in internal control and any fraud that involves management or other employees who have a significant role in internal control.
- The certifying officers must state that they are responsible for establishing and maintaining ICFR, to provide reasonable assurance of the reliability of the financial reporting and the preparation of financial statements in accordance with U.S. GAAP.
- The certifying officers must disclose any change in the company's internal control over financial reporting that, during the most recent quarter, has materially affected or is reasonably likely to materially affect the company's ICFR.

2. Reports on Internal Controls Over Financial Reporting – Section 404 ¹²

Section 404 of the Sarbanes-Oxley Act institutes a new reporting model that requires management's assessment of ICFR and the related auditor's report on ICFR to be included in a company's annual report on Form 10-K filed with the SEC. The SEC strongly encourages registrants to include the internal control reports in annual reports to shareholders as well.

¹² For a more in-depth discussion of the reporting requirements resulting from the Sarbanes-Oxley Act, see Appendix E.

As directed by Section 404 of the Sarbanes-Oxley Act of 2002, the SEC adopted rules requiring companies subject to the reporting requirements of the Securities Exchange Act of 1934, other than registered investment companies, to include with their annual reports the following: ^{ix}

1. A report of management on the company's ICFR. The internal control report must include:
 - a. a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company;
 - b. management's assessment of the effectiveness of the company's ICFR as of the end of the company's most recent fiscal year;
 - c. a statement identifying the framework used by management to evaluate the effectiveness of the company's ICFR; and
 - d. a statement that the registered public accounting firm that audited the company's financial statements included in the annual report has issued an attestation report on management's assessment of the company's ICFR.
2. The attestation report of the independent registered public accounting firm.

The new reports resulting from the Sarbanes-Oxley Act that investors began seeing with the filing of annual reports with year ends subsequent to November, 15, 2004 are the following:

a) Management's Report

Management states its responsibility for maintaining adequate internal control over financial reporting and gives its assessment of whether or not internal control over financial reporting is effective. According to the rules, management cannot state that internal control over financial reporting is effective if even one material weakness exists at year-end.

b) Auditors' Reports

The content of the auditor's report is prescribed by the PCAOB standards. The independent auditor evaluates and reports on the fairness of management's assessment. The auditor also performs an independent audit of ICFR and issues an opinion on whether internal control is operating effectively as of the assessment date (i.e., the company's fiscal year-end). If one or more material weaknesses exist at the company's fiscal year-end, the auditor cannot conclude that ICFR is effective.

As in the past, the independent auditor also issues an opinion on whether the company's published financial statements are presented fairly in all material respects in accordance with U.S. GAAP. This report may be combined with the auditor's report on ICFR, or it may be presented separately.

c) Internal Control Deficiencies and Material Weaknesses

When an internal control deficiency is identified, management and the independent auditor evaluate its significance and determine whether it constitutes a control deficiency, a significant deficiency, or a material weakness. All identified material weaknesses that exist at the company's fiscal year-end must be disclosed in the public reports issued by management and the auditor. If one or more material weaknesses exist at the company's fiscal year-end, management and the auditor must conclude that ICFR is not effective and thus issue an adverse opinion on the effectiveness of ICFR. Both the SEC chief accountant and the PCAOB chairman have stated publicly that they expect management's report to disclose the nature of any material weakness, in sufficient detail to enable investors and other financial statement users to understand the weakness and evaluate the circumstances underlying it. The PCAOB standards also requires that the independent auditors' report provide specific information about the nature of any material weakness and the actual and potential effect on the company's financial statements.

A material weakness does not mean that a material misstatement has occurred or will occur, but that it could occur. SEC Chairman William H. Donaldson before the House Committee on Financial Services on April 21, 2005 said the following about material weaknesses:

"It is important to note that investors will benefit from receiving full disclosure regarding any material weaknesses that are found — disclosure about the nature of any material weakness, their impact on financial reporting and the control environment, and management's plans for remediating them...There can be many different types of material weaknesses and many different factors may be important to the assessment of any particular material weakness. A material weakness in internal controls should not alone necessarily be motivation for immediate or severe market reaction. When armed with sufficient information about weaknesses and remediation plans, investors appear to be making reasoned judgments about whether those disclosures affect the mix of information they use to make investment decisions. The goal should be continual improvement in controls over financial reporting and increased investor information and confidence."

VI. Oversight – Monitoring and Enforcement

A. Monitoring of U.S. Public Companies¹¹

The Sarbanes-Oxley Act, particularly under Section 301, 302 and 404, mandates increased oversight of a public company's financial reporting process by its officers and audit committee.

1. Independent Auditors

In addition to a public company's internal monitoring and oversight functions (i.e. the company's officers, internal audit department and audit committee), public companies are also required to have annual audits and interim reviews of their financial statements performed by their independent auditors. Furthermore external auditors are required to audit and report on management's assessment of

the effectiveness of internal control over financial reporting in accordance with Public Company Accounting Oversight Board ("PCAOB") Auditing Standard No. 2, *An Audit of Internal Control over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. When performed in conjunction with the audit of the entity's annual financial statements for the same period, it is known as an integrated audit.

a) Components of an Integrated Audit

An integrated audit includes the following:

- Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements
- Inquiring directly of management and the audit committee regarding its views about the risk of fraud and whether the audit committee has knowledge of any fraud or suspected fraud affecting the company
- Assessing the accounting principles used and significant estimates made by management
- Evaluating the overall financial statement presentation
- Evaluating management's assessment of the company's ICFR and evaluating the effectiveness of the company's ICFR
- Examining, on a test basis, evidence supporting the design and operating effectiveness of the company's ICFR.

b) Reasonable Assurance

An integrated audit is planned and performed to obtain reasonable, rather than absolute, assurance about whether (1) the financial statements are free of material misstatement, whether caused by error or fraud, and (2) the company has maintained, in all material respects, effective internal control over financial reporting as of the date specified in management's assessment. Because of the characteristics of fraud, a properly planned and performed audit may not detect a material misstatement. Accordingly, there is some risk that a material misstatement of the financial statements or a material weakness in ICFR would remain undetected. Also, an integrated audit is not designed to detect error or fraud that is immaterial to the financial statements or deficiencies in ICFR that, individually or in combination, are less severe than a material weakness.

2. Securities and Exchange Commission¹

Section 408 of the Sarbanes-Oxley Act mandates that the SEC review every public company's Forms 10-K at least once every three years.

Though it is the primary overseer and regulator of the U.S. securities markets and accounting compliance, the SEC works closely, when necessary, with many other institutions, including Congress, other federal departments and agencies, self-regulatory organizations (e.g. the stock exchanges), state securities regulators, and various private sector organizations to execute its monitoring and enforcement function.

B. Enforcement Against U.S. Public Companies^{i xiii}

Crucial to the SEC's effectiveness is its enforcement authority.¹³ Each year the SEC brings between 400-500 civil enforcement actions against individuals and companies that break the securities laws. Typical infractions include insider trading, accounting fraud, and providing false or misleading information about securities and the companies that issue them.

Title 9 of the Sarbanes-Oxley Act increases the various penalties for white-collar crime, including mail, wire, and securities fraud. Specifically, Section 906 requires management certification that financial statements filed with the SEC are fairly stated and comply fully with provisions of the '34 Exchange Act. In addition, Section 906 imposes criminal penalties for officers who provide certification knowing it to be untrue.

The SEC's enforcement staff conducts investigations of possible violations of securities laws, including the Sarbanes-Oxley Act, and recommends Commission action when appropriate, either in a federal court or before an administrative law judge, prosecutes the SEC's civil suits in the federal courts and in administrative proceedings, and negotiates settlements on behalf of the SEC. While the SEC has civil enforcement authority only, it works closely with various criminal law enforcement agencies throughout the country to develop and bring criminal cases when the misconduct warrants more severe action.

The SEC has the authority to take enforcement action against U.S. registered public companies, their independent auditors, and other professionals. The SEC issues Accounting and Auditing Enforcement Releases ("AAERs") to announce enforcement actions involving registrants, their officers and other key employees, and independent auditors. The cases decided by the SEC in the accounting and auditing areas are typically concerned with departures from U.S. GAAP and inadequate disclosures in financial statements filed with the SEC, deficiencies in the auditing procedures followed by auditors, and the lack of independence of auditors.

C. Monitoring of U.S. Public Companies' Independent Auditors^x

The PCAOB is a private sector, non-profit corporation created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair and independent audit reports for companies whose securities are sold to, and by and for, public investors. As of April 2003, the PCAOB became the authoritative body for auditing standards for audits of U.S. publicly traded companies, taking that responsibility away from the AICPA and the accounting profession which utilized a system of peer review. This was one of many significant changes implemented through the Sarbanes-Oxley Act.

The PCAOB, under Section 103 of the Sarbanes-Oxley Act, is responsible for all auditing, attestation, quality control, ethics and independence standards applicable to

¹³ For a more in-depth discussion of the function of the SEC's Division of Enforcement, see Appendix A.

registered public accounting firms in the preparation and issuance of audit reports included in filings of annual reports of public companies, and to enforce compliance with rules pertaining to audit reports.

Public accounting firms are now required to register with the PCAOB in order to be eligible to audit public companies subject to the U.S. securities laws. One of the key responsibilities of the PCAOB is to conduct regular inspections of each registered accounting firm to ensure that the firm and its professional practitioners are in compliance with the Sarbanes-Oxley Act, PCAOB rules and standards, SEC rules and standards, as well as professional standards (such as those established by the AICPA). The PCAOB submits an annual report to the SEC.

D. Enforcement Against U.S. Public Companies' Independent Auditors ^{xi}

The PCAOB's enforcement staff conducts investigations into possible violations of any provisions of the Sarbanes-Oxley Act of 2002, any professional standards, any rules of the PCAOB or the SEC, or any provisions of the U.S. securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the SEC issued under the Sarbanes-Oxley Act, or professional standards.

When violations are detected, the PCAOB will hold a hearing and impose sanctions, as appropriate, which may range from monetary penalties and remedial measures, such as training, new quality control procedures, or the appointment of an independent monitor, to barring the firm or individual from future audits of public companies.

Appendix A: Securities and Exchange Commission

Mandate and Scope ^{xii}

As an independent, nonpartisan, regulatory agency, the primary mission of the U.S. SEC is to protect investors and maintain the integrity of the securities markets. The SEC strives to accomplish this mandate by administering federal laws that seek to ensure that the securities markets, and the public companies that trade on them, are fair and honest by requiring that public companies and their auditors comply with standard accounting and auditing practices, respectively, and by enforcing the securities laws when necessary.

The SEC also oversees the PCAOB which was created by the Sarbanes-Oxley Act of 2002. Under the securities laws, including the Sarbanes-Oxley Act of 2002, the SEC has the responsibility to develop accounting standards to be used by public companies. Despite the fact that it has historically relied on the FASB in the private sector for this function, the SEC retains the statutory authority to establish standards if it so chooses.

The SEC also oversees other key participants in the securities world, including stock exchanges, broker-dealers, investment advisors, mutual funds, and public utility holding companies. Here again, the SEC is concerned primarily with promoting disclosure of important information, enforcing the securities laws, and protecting investors who interact with these various organizations and individuals.

The laws and rules that govern the securities industry in the United States derive from a simple and straightforward concept: all investors, whether large institutions or private individuals, should have access to certain basic facts about an investment prior to buying it. To achieve this, the SEC requires public companies to disclose meaningful financial and other information to the public, which provides a common pool of knowledge for all investors to use to judge for themselves if a company's securities are a good investment. Only through the steady flow of timely, comprehensive and accurate information can people make sound investment decisions.

Source: SEC website

SEC Reporting Requirements ^{viii}

Securities Act of 1933 Reporting Requirements

The purpose of the Securities Act of 1933 ("the '33 Act") is to regulate the initial offering and sale of securities. The '33 Act requires that the representations made in registration statements filed under this Act be accurate and prohibits false and misleading statements under penalty of fine, imprisonment or both. A discussion of the individual '33 Act forms and their principal uses are beyond the scope of this whitepaper.

Securities Exchange Act of 1934 Reporting Requirements

The Securities Exchange Act of 1934 ("the '34 Act") covers periodic reporting requirements for companies with publicly registered securities. The '34 Act requirements apply to companies registered on a national exchange or companies with at least 500 shareholders and at least \$10 million in assets.

The objectives of the '34 Act are:

- To ensure that significant financial and other information regarding the issuers of publicly traded securities is made available to investors
- To regulate the securities markets and prevent unfair practices in such markets
- To regulate insider trading

SEC Rules and Required Disclosures in Reporting ^{ix}

Regulation S-X

Regulation S-X prescribes the form and content of the financial information that is required to be filed with the SEC by all issuers. Regulation S-X is comprised of 13 Articles (see box at right) that prescribe the form and content of the audited and unaudited financial statements that are included in the registration statements (i.e. the 10-K and 10-Q) that are filed with the SEC. Regulation S-X also contains the rules concerning auditor independence and auditor reports with respect to these financial statements that apply to all issuers.

- Rules 3-01 through 3-04 specify the basic financial statements of the registrant to be filed. For example, audited balance sheets are generally required as of the end of the two most recent fiscal years and audited statements of income (loss) and of cash flows are generally required for each of the three most recent fiscal years. Unaudited interim financial statements are also typically required.
- Rules 3-05, 3-09, 3-10, and 3-16 specify circumstances when other financial statements may be required.
- Rules 3A-01 to 3A-05 governs the preparation of consolidated and combined financial statements.
- Rules 4-01 through 4-10 are the rules of general application and include requirements for financial statement footnote disclosures.

Regulation S-K

Regulation S-K consists of disclosure provisions relating to substantially all non-financial statement information in most filings with the SEC. The disclosure requirements of Regulation S-K pertain to information that is generally not a part of the financial statements on which the auditors express their opinion. However, the information is often financially driven or may be a summarization of the financial information.

Regulation S-K requires the following information:

- General information about the company and descriptions of the registrant's business, properties and securities.

Regulation S-X Articles

Article 1: Application of Regulation S-X
Article 2: Qualification and Reports of Accountants
Article 3: General Instructions as to Financial Statements
Article 3A: Consolidated and Combined Financial Statements
Article 4: Rules of General Application
Article 5: Commercial and Industrial Companies
Article 6: Registered Investment Companies
Article 6A: Employee Stock Purchase, Savings and Similar Plans
Article 7: Insurance Companies
Article 9: Bank Holding Companies
Article 10: Interim Financial Statements
Article 11: Pro forma Financial Information
Article 12: Form and Content of Schedules

Note: There is no Article 8.

- Supplementary financial information and management's discussion and analysis of the financial condition and results of the operations.
- Information about members of senior management and certain security holders.
- Registration statement and prospectus provisions.
- Exhibits and other miscellaneous information.

The information prescribed by an item of Regulation S-K is required in an SEC filing only to the extent called for by a '33 Act or '34 Act form or schedule. While auditors generally do not express an opinion on this information, auditors do have an obligation to read all items and make sure that the information presented is consistent with the information in the audited financial statements.

In addition to Regulation S-X and S-K, the SEC also issues other rules and regulations. They are:

Financial Reporting Releases

The SEC issues Financial Reporting Releases (FRRs) to amend the rules and regulations related to financial reporting and to announce accounting and auditing policies. Many of the explanatory comments in the FRRs are included in a Codification. These comments supplement the rules set forth in Regulations S-X and S-K. The SEC considers FRRs to be authoritative statements regarding the subjects covered therein.

Staff Accounting Bulletins (SABs)

Staff Accounting Bulletins are issued by the SEC staff to disseminate the administrative interpretations and practices followed by the Division of Corporation Finance and the Office of the Chief Accountant in administering the disclosure requirements of the securities laws. Although the statements in SABs are not rules or regulations of the SEC, SABs reflect the SEC staffs' views regarding accounting-related disclosure policies and departures from their provisions could be viewed as departures from SEC rules and regulations. Examples of SABs issued by the SEC include:

- SAB No. 107 (March, 29, 2005) Share-based Payments
- SAB No. 105 (March, 9, 2004) Loan Commitments as Derivative Instruments
- SAB No. 101 (December 3, 1999) Revenue Recognition
- SAB No. 100 (November 24, 1999) Restructuring Activities
- SAB No. 99 (August 13, 1999) Materiality

Staff Legal Bulletins

Staff Legal Bulletins (SLBs) are issued by SEC staff to summarize their legal interpretation of the federal securities laws and SEC regulations. SLBs represent interpretations and policies followed by the Divisions of Corporation Finance, Market Regulation, or Investment Management. Because SLBs represent the views of the SEC staff, they are not legally binding.

SEC Division of Enforcement ^{xiii}

The SEC's enforcement staff conducts investigations of possible violations of securities laws, recommends SEC action when appropriate, either in a federal court or before an

administrative law judge, prosecutes the SEC's civil suits in the federal courts and in administrative proceedings and negotiates settlements on behalf of the SEC. While the SEC has civil enforcement authority only, it works closely with various criminal law enforcement agencies throughout the country to develop and bring criminal cases when the misconduct warrants more severe action.

The Enforcement Division obtains evidence of possible violations of the securities laws from many sources, including its own surveillance activities, other divisions of the SEC, the self-regulatory organizations and other securities industry sources, press reports, and investor complaints.

Once the SEC issues a formal order of investigation, the Enforcement Division's staff may compel witnesses by subpoena to testify and produce books, records, and other relevant documents. Following an investigation, the staff presents their findings to the SEC for its review. The SEC can authorize the staff to file a case in federal court or bring an administrative action. Individuals and companies charged sometimes choose to settle the case, while others contest the charges.

Under the securities laws, the SEC can bring enforcement actions either in the federal courts or internally before an administrative law judge. The factors considered by the SEC in deciding how to proceed include: the seriousness of the wrongdoing, the technical nature of the matter, tactical considerations, and the type of sanction or relief to obtain. Often, when the misconduct warrants it, the SEC will bring both proceedings.

Appendix B: Financial Accounting Standards Board^{xiv}

The FASB is the private-sector organization empowered by the SEC to establish financial accounting and reporting standards. The mission of the FASB is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information.

To accomplish its mission, the FASB acts to:

- Improve the usefulness of financial reporting by focusing on the primary characteristics of relevance and reliability and on the qualities of comparability and consistency;
- Keep standards current to reflect changes in methods of doing business and changes in the economic environment;
- Consider promptly any significant areas of deficiency in financial reporting that might be improved through the standard-setting process;
- Promote the international convergence of accounting standards concurrent with improving the quality of financial reporting; and
- Improve the common understanding of the nature and purposes of information contained in financial reports.

FASB Conceptual Framework^{xv}

The FASB develops broad accounting concepts as well as standards for financial reporting. It also provides guidance on implementation of standards. Concepts are useful in guiding the FASB in establishing standards and in providing a frame of reference, or conceptual framework, for resolving accounting issues. The framework helps to establish reasonable bounds for judgment in preparing financial information and to increase understanding of, and confidence in, financial information on the part of users of financial reports. It also helps the public to understand the nature and limitations of information supplied by financial reporting.

Appendix C: Public Company Accounting Oversight Board^x

The PCAOB is a private sector, non-profit corporation created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair and independent audit reports for companies whose securities are sold to, and by and for, public investors.

As of April 2003, the PCAOB became the authoritative body for auditing standards for audits of U.S. publicly traded companies, taking that responsibility away from the AICPA and the accounting profession. This was one of many significant changes implemented through the Sarbanes-Oxley Act.

Section 103 of the Sarbanes-Oxley Act of 2002 requires the PCAOB to establish or adopt, or both, auditing and related attestation, quality control, ethics, independence and other standards to be used by registered public accounting firms in the preparation and issuance of audit reports include in filings of annual reports of public companies, and to enforce compliance with rules pertaining to audit reports.

The PCAOB adopted all existing AICPA auditing standards, to the extent that they have not been superseded by subsequent PCAOB pronouncements. The PCAOB has also issued several new standards addressing such topics as audit documentation and audits of ICFR. In the development of its standards and rules, the PCAOB solicits the input of the AICPA, accounting firms, public companies, investors and others. Standards are not effective until approved by the SEC. The AICPA continues to be responsible for setting generally accepted auditing standards for all nonpublic entities. As mentioned above, AICPA standards also apply to the audits of public companies unless superseded by a PCAOB pronouncement.

Public accounting firms are now required to register with the PCAOB in order to be eligible to audit public companies subject to the U.S. securities laws. The PCAOB is responsible for all auditing, attestation, quality control, ethics and independence standards applicable to registered public accounting firms. One of the key responsibilities of the PCAOB is to conduct regular inspections of each firm to ensure that the firm and its professional practitioners are in compliance with the Sarbanes-Oxley Act, PCAOB rules and standards, SEC rules and standards, as well as professional standards (such as those established by the AICPA). Firms suspected to be in violation of those standards during or outside of a regular inspection can be investigated and later be fined, have their registration revoked or be levied alternative penalties (such as not taking on new clients for a set period of time).

The PCAOB's enforcement staff conducts investigations into possible violations of any provisions of the Sarbanes-Oxley Act of 2002, any professional standards, any rules of

the PCAOB or the SEC, or any provisions of the U.S. securities laws relating to the preparation and issuance of audit reports.

Section 105 of the Sarbanes-Oxley Act grants the PCAOB broad investigative and disciplinary authority over registered public accounting firms and persons associated with such firms. The PCAOB established rules for the investigation and discipline of registered public accounting firms and associated persons of such firms. Under the adopted rules, the PCAOB and its staff may conduct investigations concerning any acts or practices, or omissions to act, by registered public accounting firms and persons associated with such firms, or both, that may violate any provision of the Sarbanes-Oxley Act, the rules of the PCAOB, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the SEC issued under the Sarbanes-Oxley Act, or professional standards. The PCAOB's rules require registered public accounting firms and their associated persons to cooperate with Board investigations, including producing documents and providing testimony. The rules also permit the PCAOB to seek information from other persons, including clients of registered firms.

When violations are detected, the PCAOB will hold a hearing and impose sanctions, as appropriate, which may range from monetary penalties and remedial measures, such as training, new quality control procedures, or the appointment of an independent monitor, to barring the firm or individual from future audits of public companies.

Appendix D: Current U.S. GAAP Pronouncements

(Note: this appendix includes GAAP Hierarchy Level A pronouncements only, some of which may have been superseded by subsequent pronouncements)

FASB Statements ("FAS")

FAS 1	Disclosure of Foreign Currency Translation Information
FAS 2	Accounting for Research and Development Costs
FAS 3	Reporting Accounting Changes in Interim Financial Statements — an amendment of APB Opinion No. 28
FAS 4	Reporting Gains and Losses from Extinguishment of Debt — an amendment of APB Opinion No. 30
FAS 5	Accounting for Contingencies
FAS 6	Classification of Short-Term Obligations Expected to Be Refinanced — an amendment of ARB No. 43, Chapter 3A
FAS 7	Accounting and Reporting by Development Stage Enterprises
FAS 8	Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements
FAS 9	Accounting for Income Taxes — Oil and Gas Producing Companies — an amendment of APB Opinions No. 11 and 23
FAS 10	Extension of "Grandfather" Provisions for Business Combinations — an amendment of APB Opinion No. 16
FAS 11	Accounting for Contingencies — Transition Method — an amendment of FASB Statement No. 5
FAS 12	Accounting for Certain Marketable Securities
FAS 13	Accounting for Leases
FAS 14	Financial Reporting for Segments of a Business Enterprise
FAS 15	Accounting by Debtors and Creditors for Troubled Debt Restructurings
FAS 16	Prior Period Adjustments
FAS 17	Accounting for Leases — Initial Direct Costs — an amendment of FASB Statement No. 13
FAS 18	Financial Reporting for Segments of a Business Enterprise — Interim Financial Statements — an amendment of FASB Statement No. 14
FAS 19	Financial Accounting and Reporting by Oil and Gas Producing Companies
FAS 20	Accounting for Forward Exchange Contracts — an amendment of FASB Statement No. 8
FAS 21	Suspension of the Reporting of Earnings per Share and Segment Information by Nonpublic Enterprises — an amendment of APB Opinion No. 15 and FASB Statement No. 14
FAS 22	Changes in the Provisions of Lease Agreements Resulting from Refundings of Tax-Exempt Debt — an amendment of FASB Statement No. 13
FAS 23	Inception of the Lease — an amendment of FASB Statement No. 13
FAS 24	Reporting Segment Information in Financial Statements That Are Presented in Another